

# **Is There a Role for a State Utility Commission in the Corporate Governance Reform Movement?**

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*State regulatory commissions are in the midst of the most complicated and controversial regulatory environment in well over 50 years. Unfortunately some of the new issues will require an extension of concern beyond the regulated utilities and into the parent holding companies businesses and corporate governance structures where their regulatory jurisdiction is less certain. In a very summary way here are the major problems that have created this stressful environment where investor and ratepayer share a common cynicism regarding many of the actors in the energy industry.*

## **ENRON**

As the Enron debacle continues to unfold in all of its sordid and unethical details, there is a renewed interest in how it all happened with the many back-up systems inside the company and why the public auditors failed to meet their fiduciary responsibilities. And why the public watchdog agencies turned out to be so ineffective when confronted with overwhelming fraud and deception. The list of other very troubled companies and auditors and stock analysts and lawyers and directors of major corporation grows everyday and demands the attention of state regulatory commissions who are charged with making sure that similar outrages do not happen on their watch.

## **MARKET POWER**

Notwithstanding the emergence of some competitive successes in energy markets, there are troubling dislocations emerging in the form of that old nemeses “market power.” Once again it is a material concern of the FERC and PJM and several states that are closely monitoring

*\*The views expressed herein are those of Fred Grygiel and do not necessarily reflect the views of the State of New Jersey, the New Jersey Board of Public Utilities, the Commissioners, or other members of the NJBPU Staff.*

marketing behavior.<sup>1</sup> Ratepayers are concerned that these recently deregulated wholesale electricity markets may not be providing fair prices.

## **DIVERSIFICATION**

In the midst of all of this turmoil, far too many regulated utilities are in holding companies where the unregulated subsidiaries are heavily involved in the latest wave of diversifications that have again failed to meet the rosy financial expectations trumpeted to the “Street” just a few years ago. The typical hype by Wall Street is nicely captured in a 1993 *Wall Street Journal* Industry Focus article entitled, “U.S. Electric Companies See Promised Land Elsewhere” and subtitled “With a Mature Domestic Market, Opportunities for Utilities are Overseas.”<sup>2</sup> Now some of these utilities face potential harm to their credit ratings, reduced access to capital markets, and most bothersome the scrutiny of their state commissions who must inevitably be involved in the clean-up of these corporate misadventures while at the same time preparing to handle potentially painful rate increase cases in an environment filled with the mistrust and skepticism born of Enron/Arthur Andersen/WorldCom/ et al.<sup>3</sup>

Unfortunately the current diversification wave in the energy industry is the third in the last three decades resulting in a casualty list that chronicles the major destruction of shareholder value.<sup>4</sup> Arguably, these non-regulated investments are financed to some degree by ratepayer revenues that ultimately are paid-up to the holding company “owners” of the utilities who keep some of it for reinvesting in expected higher return unregulated projects with the remainder being paid out as dividends to stockholders. As some of these failed projects hit the front page of the *Wall Street Journal*<sup>5</sup> and inevitably the front pages of the largest state newspapers, there will be calls for state commissions to investigate these failed investments

and to protect ratepayers from the financial problems plaguing the parent holding companies in the form of liquidity crises and in some cases bankruptcy.<sup>6</sup> Failed diversification takes on added significance when the financial integrity of your local utility could be destroyed.

## **RATE CASES**

There is yet another “wave” on the horizon,<sup>7</sup> one that directly impacts ratepayers.

Commissions are now processing utility rate cases that were artificially delayed over the last four to five years as part of complex state electric industry restructuring agreements. Often these agreements provided for mandatory rate reductions while regulators implemented a variety of retail choice programs, which they believed, would ultimately lead to lower rates and related benefits of competition. For a variety of complicated reasons, retail choice to date has neither delivered the economic benefits nor real choice in most retail markets.<sup>8</sup> The old refrain “rate shock” has come back into the press coverage of state commissions girding for rate increase decisions that will be made later this year and into 2004.

## **CORPORATE GOVERNANCE**

And finally, one must examine corporate governance. Recent federal legislation, the Sarbanes-Oxley Act of 2002,<sup>9</sup> (“Sarbanes-Oxley”) is aimed at fixing various perceived corporate governance problems traceable to the failure of outside auditors and audit committees to meet their fiduciary obligations. Along with the recent major policy recommendations by the New York Stock Exchange<sup>10</sup> and the NASD<sup>11</sup>, they comprise the essence of the most recent element of the growing corporate governance reform movement in the U.S. State regulatory commissions will come under some pressure to assume some role in making sure that these perceived corporate governance defects for listed companies do not

adversely affect their owned regulated utilities and ultimately their ratepayers. So what can a state regulatory commission do to make sure that their ratepayers' interests are protected and insulated from any financial harm associated with these problems?

## **A Seven-Step Plan to Protect Ratepayers' Interests during the Corporate Governance**

### **Reform Era: One View**

Although each commission will need to decide if their regulated utilities are impacted and will choose their own process for deciding how to study corporate governance problems in its state, the seven steps noted below are preliminary observations and subject to modifications as the SEC formalizes its specific rules governing auditors and audit committees. Other directives may emerge affecting the selection and retention of corporate directors for all companies listed on major exchanges.

1. Carefully review state statutes and any commission orders authorizing the formation of holding companies owning state utilities to fully understand the jurisdiction over implementation of corporate governance changes at the holding company level.
2. Form an ad hoc staff working group to fully review Sarbanes-Oxley, all related SEC actions, and the policy pronouncements made by the major exchanges. In addition, it might be a good time for the commission staff to review the impact of existing anti-takeover devices used by holding companies to shield itself from unwanted potential takeovers and dissident shareholder groups. Although controversial there is some evidence that these

devices shield the incumbent management from appropriate shareholder pressures to reduce costs and rationalize business plans to the long run detriment of shareholder interests. This overall review of corporate governance should result in a calendar of compliance events for the holding company that the commission can use to effectively monitor its progress toward more effective governance.

3. Negotiate or order holding companies to file their compliance plans with the commission including a full explanation of how the regulated utility will be affected by their plan and how the costs of compliance will be allocated.
4. Determine if there are any specific provisions beyond the Sarbanes-Oxley Act that the commission would like adopted at the utility level such as the mandatory rotation of auditors after a set number of years even though at the holding company level no such rotation is required under the Sarbanes-Oxley Act. Here, the question of jurisdiction becomes critical.
5. Develop a periodic corporate governance review process to assure ongoing compliance by the holding company with all SEC requirements. Numerous companies, including rating agencies are now developing methods for quantifying the quality of corporate governance and its potential impact on shareholder value. This analysis can be built into rate reviews, management audits, or other appropriate state proceedings.

6. Consider recommending the establishment by the parent holding company of a utility committee as part of the holding company's family of committees to insure explicit consideration of utility ratepayers' vulnerability to failed non-regulated investments and corporate governance defects. To some extent this initiative is comparable to the enhanced role for the audit committee where financial expertise will be mandated. Where the utility is a major part of the holding company, a utility separate committee may provide needed discipline to insulate retail ratepayers and avoid conflicts with the state utility commission.
7. In the alternative, consider requiring the establishment of a separate utility board of directors who are charged by the commission with explicitly reviewing the business plans and corporate governance structure of the holding company to insure protection of the utility's ratepayers and the financial integrity of the regulated utility.

### **Questions:**

- ~~✍~~ Do state regulatory commissions have the resources? Do they really need to go through all of these efforts?
- ~~✍~~ Are there really new potential financial harms at the holding company lurking behind less than fully independent directors, less than fully independent auditors, less than fully qualified audit committees, less than fully independent stock analysts, less than fully independent investment bankers, and less than fully effective federal gatekeepers and regulatory watchdogs?

## Answers:

~~✍~~ If your commission doesn't have the resources, fight to get them A.S.A.P.

The payback will be material and have long lasting positive effects.

~~✍~~ Every day brings new revelations about corporate duplicity, accounting irregularities and governance failures. State regulators must make investigating these corporate governance issues a major part of their regulatory "due diligence" responsibilities.

~~✍~~ Lastly, when (not if) your state legislature and governor ask, "Did our public utility commission do enough to protect consumers?" hopefully your answer can be an emphatic "Yes!"

Restoring investor trust in capital markets and the electric industry is now a high priority especially in these depressed financial markets.<sup>12</sup> With utilities now returning to the rate case arena, reestablishing ratepayers' trust in the rate making process will be essential but much more difficult given the daily barrage of negative press regarding the latest failed diversification, high profile corporate governance failures, and the seemingly endless plea bargains of "rogue" traders and more studies on why markets are prone to manipulation.

In conclusion, state regulatory commissions are facing these new challenges created by numerous bad actors in the energy industry.<sup>13</sup> Add aggressive accounting practices used to shield poor performance from investors and regulators and you have an almost insurmountable barrier to restoring trust in the regulatory process. Transparency, responsibility and accountability must be the mantra of the regulator as they consider and implement corporate governance reforms. The ultimate financial pay-off to ratepayers will be

determined by each commission's efforts on behalf of their mostly captive ratepayers who don't need another Enron-Arthur Andersen disaster in their state.

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<sup>1</sup> See Federal Energy Regulatory Commission Market Oversight and Investigations unit at <http://www.ferc.gov/market-oversight/market-oversight.htm>; PJM Interconnection, L.L.C. ("PJM") Market Monitoring Unit at <http://www.pjm.com> and [http://www.pjm.com/market\\_monitoring/downloads/mmplan.pdf](http://www.pjm.com/market_monitoring/downloads/mmplan.pdf); and, for example, the Florida Public Service Commission Office of Market Monitoring & Strategic Analysis at <http://www.psc.state.fl.us/general/publications/saOO4a.pdf>, page 5.

<sup>2</sup> Martha Brannigan, "Industry Focus: U.S. Electric Companies See Promised Land Elsewhere, With a Mature Domestic Market, Opportunities for Utilities are Overseas," *The Wall Street Journal*, March 2, 1993.

<sup>3</sup> See Standard & Poor's Utilities, "Regulation and Credit Quality in the U.S. Utility Sector," January 30, 2003 by John Whitlock for a brief discussion.

<sup>4</sup> See letter to Harvey L. Pitt from the Committee on Energy and Commerce Democrats dated January 30, 2002 and the National Association of Regulatory Utility Commissioners' (NARUC) "1982 Report of the Ad Hoc Committee on Utility Diversification" from the 94<sup>th</sup> NARUC Annual Convention and referenced within that document in Chapter 8 at pp. 71-82 the "Summary of the 1972 Report of NARUC Ad hoc Committee on Non-utility Investments."

<sup>5</sup> Rebecca Smith. "Beleaguered Energy Firms Try to Share Pail with Utility Units," *The Wall Street Journal*, Section A, page 1. Thursday December 26, 2002. This was in fact a page one article above the fold and has received deserved attention from regulators.

<sup>6</sup> *Ibid.*

<sup>7</sup> Morgan Stanley Equity Research North America, Strategy, Global Electricity, In-Depth, Market Commentary/Strategy, "Déjà Vu," April 9, 2002 by Judith B. Warrick.

<sup>8</sup> For a thoughtful discussion, see the Consumer Federation of America white paper, "Nation's Recent Experience with Electricity Restructuring Reveals its Near-fatal Flaws," August 30, 2001.

<sup>9</sup> The Sarbanes-Oxley Act of 2002 (Public Law 107-204), signed into law on July 30, 2002. See full text at <http://corporate.findlaw.com/industry/corporate/docs/publ107.204.pdf>.

<sup>10</sup> New York Stock Exchange (NYSE) "Original Recommendations of the Corporate Accountability & Listing Standards Committee," June 6, 2002 ([http://www.nyse.com/pdfs/corp\\_govreport.pdf](http://www.nyse.com/pdfs/corp_govreport.pdf)), "Corporate Governance Rule Filing," August 16, 2002 ([http://www.nyse.com/pdfs/corp\\_gov\\_pro\\_b.pdf](http://www.nyse.com/pdfs/corp_gov_pro_b.pdf)) and "Shareholder Approval of Equity Compensation Plans," October 7, 2002 ([http://www.nyse.com/pdfs/corp\\_gov\\_shareholder.pdf](http://www.nyse.com/pdfs/corp_gov_shareholder.pdf)).

<sup>11</sup> NASDAQ "Summary of NASDAQ Corporate Governance Proposals," November 20, 2002 available at [http://www.nasdaq.com/about/Corp\\_Gov\\_Summary111902.pdf](http://www.nasdaq.com/about/Corp_Gov_Summary111902.pdf).

<sup>12</sup> See "EEI Action Plan to Restore Confidence in the Electric Power Industry," November 2002, Edison Electric Institute.

<sup>13</sup> Matt Andrejczak, "Ex-Enron trader pleads guilty," CBS Market Watch online, February 4, 2003.